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Panel Discussion

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Professor Sowards: At the risk of heating things up and localizing the situation on the panel discussion, three things are of interest to lawyers here in Miami and the surrounding area. Number one, can I get a few friends together and present an idea and turn it into a tangible reality? Number two, what is the liability of outside directors? And, number three, will this proposed Code place too onerous a burden on outside directors?

I would like to start the discussion, and I have questions here for Professor Loss, most of which are on getting a few friends and associates together, private offerings. The *Wall Street Journal*[1] has reported that the Commission is "off the wall" about Professor Loss' failure, in the Code's private offering exemption, to include financial sophistication and access as factors necessary to qualify for the exemption. If the reporting is accurate—and it is a fair prediction that that great newspaper reports accurately—I have great difficulty in understanding the criticism of the Code in that respect.

First of all, for forty years lawyers did not know what the private offering exemption was; I still do not know this afternoon. Professor Wolfson spoke of judicial and administrative gloss. Back in 1953, in *Ralston Purina,*[2] the Supreme Court of the United States said that a chow loading foreman[3] was not a proper offeree in a private offering. As you know, the Code switches to *purchasers,* but under current law, to qualify for the exemption, every offeree must have access to that type of information which would be in the registration statement. Just what those things mean is anybody's guess. Different administrative and judicial interpretations were given from time to time by the Commission and by the courts; and one of our distinguished panelists, Professor Kripke, remarked, before the

* The panelists were: Professor Louis Loss, Professor Homer Kripke, Professor George J. Benston, Dean Richard R. West and Professor Nicholas Wolfson. The moderator was Professor Hugh L. Sowards. The tape recording of the discussion was transcribed verbatim; however, to facilitate reader comprehension, some editing was done by members of the *University of Miami Law Review.* The changes made were strictly grammatical in nature, and the staff conscientiously attempted to retain the flavor of the discussion as it occurred.

1. Schorr, *Overhauling the Securities Laws,* Wall St. J., Dec. 21, 1978, at 16 col. 4.

2. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

3. "Among those responding to these offers were employees with the duties of artists, bakeshop foreman, chow loading foreman, clerical assistant, copywriter, electrician, stock clerk, mill officer clerk, order credit trainee, production trainee, stenographer, and veterinarian." *Id.* at 121.

enactment of that infamous rule 146, that conditions were intolerable.[4]

After the Commission's brief in a local case, *Continental Tobacco,*[5] many securities attorneys felt that there was no private offering to individuals possible under the Securities Act. So, the Commission promugated rule 146. Professor Kripke has called this a "major blunder."[6] That is an understatement! At best, for an established company, rule 146 meant more paperwork for the lawyers and more expense for the company. At worst, it meant no dice for the local start-up companies when they wanted to get a few friends together. Nothing of human achievement ever started itself. You have to have a promoter and a group which is willing to contribute.

Rule 146 is laughable insofar as a start-up company is concerned—a nightmare. The SEC itself—listen to this—two years after the promulgation of that rule, said: "[T]he Commission is aware of criticism that the Rule is hindering the investment of venture capital, and that as an experiment the Rule is a failure and should be rescinded."[7] The administrative gloss is confusing and there are conflicting interpretations. Again and again and again, the SEC tells us in policy pronouncements that the rule is not exclusive and that you can proceed under the statute which says, "transactions not involving any public offering."[8] What a joke that is!

The judicial pronouncements under the statute are no better—*Doran v. Petroleum Management Corp.*,[9] eight people is too many if they do not have the *Purina* qualifications. And finally a case, *Lawler,*[10] where an offering to *one* financially sophisticated person was not a private offering. Would not that person have had the economic clout to obtain access, if that is what they require? So, the Commission is worried that Professor Loss' 243, if that is the

4. Kripke, *SEC Rule 146: A Major Blunder*, N.Y.L.J., July 5, 1974, at 1, col. 3.

5. SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972).

6. Kripke, *supra* note 4.

7. SEC Release No. 33-5779, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,828, at 87,178 (Dec. 6, 1976).

8. SECURITIES ACT OF 1933, § 4(2), 15 U.S.C. § 77d(2) (1976).

9. 554 F.2d 893 (5th Cir. 1977). After deciding that no private offering exemption was available for the defendants, the Fifth Circuit Court of Appeal remanded for further proceedings. On remand, the case was disposed of by the granting of summary judgment in favor of defendants because the statute of limitations had run. That decision was affirmed in Doran v. Petroleum Management Corp., 576 F.2d 91 (5th Cir. 1978).

10. Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978).

number, the numbers are unimportant—of this Code,[11] an offering to thirty-five orphans is a private offering. Or, if you will, an offer to thirty-two orphans, three elderly widows and one hundred banks is private. I say "Hurray!" The second reason that it is so difficult for me to understand why they are "off the wall" at 500 North Capitol, the address of the Commission, is this: Professor Loss' section 242(b)(3) gives the Commission the power, with respect to what Professor Wolfson referred to as a "non-one-year registrant," or less than one-year registrant—a start-up company, to add, modify, let's face it, to rewrite the exemption.

How can they be "off the wall"? Let me start off with this: I say here is a refreshing breath of air. Somebody has finally given us a magic number. We did not have it for forty years. And if it is too many, twenty-five plus ten, or if there are too many orphans and widows involved, there can be a rewrite by the "watchdog." So, I agree with Professor Kripke one hundred percent—a major blunder and intolerable conditions.

I am not interested in Sullivan & Cromwell or the Pickering firm, fine as they are; I am interested in Mershon, Sawyer, a local firm, and the Miami Nail Company, not General Motors. How do we go out and raise funds?

I say this section of the Code is a distinct advancement. I would like to start with that, and I would like comments from you gentlemen and from the audience. Professor Loss, would you care to comment?

Professor Loss: May I say a few words by way of general rebuttal before I come to that question?

Professor Sowards: Yes, sir.

Professor Loss: Thank you. First of all, I want to thank you for your compliment in deciding that four-to-one odds are just about right. [Laughter.] Second, I now know what is meant when they say economics is the dismal science. Law professors do not have the luxury that economists have of being real, honest-to-God professors. The only people who consider us real professors are the practicing lawyers. The real professors consider us lawyers, not professors. And, of course, law professors have to live in both worlds to an extent, if they are going to be any good at all. Hence, principle must occasionally be tempered with practicality. As for my lawyer colleagues here, I'll make a deal with them. In future panels, I would

11. Professor Sowards is clearly referring to § 242, not § 243, in the following discussion. ALI PROPOSED FEDERAL SECURITIES CODE § 242 (Mar. 1978 Proposed Official Draft) [hereinafter cited as FED. SEC. CODE]. The editors have corrected all subsequent references to the Code sections so that they accurately reflect the speaker's intent.

not mind their toning down a little bit on the "brilliant draftsmanship" if they would also tone down a little bit on the "however." [Laughter.]

If we had set out about nine years ago to do an empirical study of each of the several hundred questions we have had to decide, my grandchildren might still be working on this Code some day. That is a simple fact of life. There was a new Internal Revenue Code in 1954. I am not aware that anybody suggested that we should have done an empirical study as to the benefits of an income tax. There are some things that you just do not do and cannot do in an imperfect world. And while I said this morning that we could not afford empirical studies on all these things, although it might be nice to have them, I do not think it is fair to go back and indicate that we tossed coins and played by hunches.

The advisory group on this study contained two very distinguished circuit judges (one of them Judge Henry J. Friendly, who has probably written more SEC opinions than most of the other judges combined, and the other Chief Judge Thomas E. Fairchild of the Seventh Circuit) as well as four or five first-rate former Chairmen and former Commissioners of the SEC (including Ray Garrett, Jr., the late Manuel F. Cohen, Professor William L. Cary, Ralph H. Demmler), four or five other academics, a dozen or so first-rate lawyers, and a member of the SEC. We did not sit around tossing coins!

It must also be remembered that, if we did not have economists and accountants in the room with us at all times, we did talk to accountants at least, and we did talk very often to representatives of trade organizations, stock exchanges, the American Institute of Certified Public Accountants, and the Investment Company Institute. I could go on and on. We had them attend some of the Advisers' meetings. The lawyers themselves who were in the advisory group represented all sorts of interests and spoke with that knowledge in mind—although I must say I never have seen a group of lawyers who divorced themselves as much from their clients' selfish interests as this bunch did over the last nine years when we worked together discussing the Code.

Furthermore, aside from the fact that we did not make formal empirical studies (and in general I think, at least as a group, one or another of us was aware of the considerable economic literature that does exist), there seems to be an implication that somehow the economists, if they had been consulted, would all have agreed about everything. They do not; the literature is all over the place. I would venture to guess that if we had done empirical studies, when they were all finished, there would have been just as much dissension as there was agreement. Well, I do not want to expatiate on that any further.

On the limited offering, somebody said—I guess it was my former friend Wolfson, who comes here an extremely well-trained fellow——

Professor Sowards: You did not give him an "A" like that fellow Sarbanes[12] who is introducing the bill? [Laughter.]

Professor Loss: I think it was he who said that we may have picked thirty-five without any idea of the impact.[13] The impact is pretty obvious. If you liberalize the private offering exemption, which is what the limited offering does, more people are going to use it. How many more? I do not think any economist could tell us how many more. A substantial number of people are going to use it.

Now what is the philosophy? It is not hit or miss. The philosophy is simply this—and this needs to be said not only with respect to the limited offering exemption but also generally. When the Securities Act was passed, it was the first piece of federal legislation on the books. There were blue sky laws, but, until the last decade or two, they were rather spottily enforced, not well-drafted, and one could not rely on them very much. Since the Securities Act came along, we have developed a very substantial number of additional protective devices. We have the regulation of the exchanges; we have the regulation of brokers and dealers and investment advisers; we have the self-regulatory organizations; we have much more effective blue sky laws and blue sky commissioners.

After all these years, to pretend that somehow little old section 5 of the Securities Act of 1933 is still the center of the SEC universe is just silly. It is not. There are far better disclosure devices. The annual report to stockholders is one, and we have, for the first time, given the Commission authority over the contents of that document. And the theory of loosening up on the private offering exemption (and I shall say a word in a moment, if I may, about the intrastate exemption) was that, after all, registration in today's Securities Act sense means hauling out the heavy federal artillery. You do not need heavy federal artillery in every case.

When there is an offering that, in this huge country, ends up with not more than thirty-five widows and orphans, plus institu-

12. Senator Paul S. Sarbanes from Maryland; *see* Loss, *Keynote Address: The Federal Securities Code*, 33 U. MIAMI L. REV. 1431, 1448 (1979).

13. *See* Wolfson, *Comments on the Proposed Federal Securities Code: Transformation of the Securities Act of 1933*, 33 U. MIAMI L. REV. 1495, 1504 (1979).

tions that can take care of themselves, one can afford to rely on the other protections—particularly, the vast expansion of the antifraud provisions, which, if anything, are further expanded in the Code.

Now, you might not like that; you might not agree with that philosophy. I am not sure the Commission agrees. I do not know where that *Wall Street Journal* statement was——

Professor Sowards: Burt Schorr.

Professor Loss: He talked to me, but I did not tell him that.

Professor Kripke: Lou, assume that the *Wall Street Journal* report is accurate, and judging from the way the Commission usually behaves, I would guess that it might be accurate. My question is this: If the SEC is foolish enough and absolutist enough in its approach to refuse to see the cost/benefit issues of freeing up private placements for thirty-five people, without insisting on coming in like Sir Galahad to protect everybody, if it is foolish enough about that, did we not make a mistake in giving it so much discretionary rulemaking power all the way through this statute?

Professor Loss: Well, Homer, I do not think we have any choice about rulemaking power. One could not write a code without giving them a great deal of rulemaking power.

Professor Kripke: Why not?

Professor Loss: It just would not work.

Professor Kripke: Well, does not the rulemaking power become the come-on which we hope will get them to support the Code, because we told them, in effect, "Anything you do not like you can change."

Professor Loss: I do not think we have said that. We have said that in regard to non-one-year registrants. Again, Professor Wolfson pointed out that this has an adverse impact on small business. Well, of course it does. Everything has an adverse impact—all regulations have an adverse impact on small business.

It is one of the dilemmas of this country that "small business" is the darling of Congress (the center of the American economy and all that) and, at the same time, that is where most of the fraud is. That is not to say that small businessmen are inherently more fraud-prone than are executives in the Fortune 500. The latter are just like politicians who have become statesmen: they are the successful people; they can afford to be considerably more moralistic and ethical. The fact is that we have tremendous mortality among small businesses, and that is where you need protection. So, with respect to non-one-year registrants, we give the Commission rather complete power. One could argue our decision with respect to those that have been continually registered for over one year, but as to those, we think we can loosen up a bit and rely on the other protections.

Professor Sowards: Yes, but I am worried about the local Miami company that wants to go public later and wants to crawl before it walks. I am interested in non-one-year registrants. Can I get a few friends together and——

Dean West: Would you permit a comment on that relating back——

Professor Sowards: May I finish?

Dean West: Oh, sure, I am sorry.

Professor Sowards:——turn an idea into a tangible reality? I get this question four or five times a week. If I can go—and I can go with your thirty-five orphans, that I will buy. What I do not like is that, and I hope I am not exaggerating, for these non-one-year registrants, the Miami Nail Company, the start-up crowd, the Commission can rewrite it, rule 146 me, and put me back to square one in that nightmare.

Professor Loss: Well, first of all, the comments will say that we hope not to see anything like rule 146 even in that area. But, of course, that will not bind the Commission. Beyond that, I do not know what I can say to you except that it is much nicer to be successful and rich than to be unsuccessful and poor. When you are a start-up company, more protection is needed, and I think the Commission would be quite right in that area in saying that a promotional company ought not go to thirty-five widows and orphans.

Now, reasonable people might differ about that. Again, I do not want to be accused of being too political, but it would be rather easy, I think, for the SEC to persuade Congress that we were wrong in taking away their rulemaking authority as to non-one-year registrants. I am hoping in the one-year registrant situation we can get by without rulemaking authority; I am not sure. That is what the *Wall Street Journal* said.

Professor Sowards: You know, Lou, if I represent a group that wants to get money from a few friends and associates and I am rule 146ed, I might as well register; and I cannot do that. I do not have that money to pay my lawyer, my printer, my accountant, and so forth.

Professor Loss: Well, there would still be Regulation A, which is——

Professor Sowards: I know, but really a junior form of registration.

Professor Loss: It is about half as expensive, but it is better than nothing.

Professor Kripke: Well, we seem to be at a point where Lou must be doing something right, because the Commission objects that he is too liberal and Professor Sowards objects that he is not liberal enough. Generally speaking, I agree with what Lou has tried to say, that his limited offering exemption is a great advance over the present situation. The question in my mind is whether, even in the start-up company which is not a one-year registrant, the Commission has any genuine basis for interfering, because their own efforts to force registration have by no means been proved to do the public any good. Their own record on start-up company registrations is far from showing that they have achieved any protection for the public.

Dean West: But what they have done almost certainly is stop some companies from going public. It is true that some companies have failed, but some also succeed if you give them a chance. The question is: How many companies which could have made it, and made a lot of money for people, were unable to?

It is back to George Benston's earlier point. I do not care whether it is this area, or the drug area, or a whole variety of others, if you take all the risk out of it, you take all the fun out of it—and the possibility of the return.

Professor Loss: Well, it is some of you economists, I think, rather than the lawyers, who have suggested that, realistically, perhaps we ought to recognize that new small businesses cannot be publicly-financed and should not be publicly-financed. I do not say that, but I have heard some economists say that.

Dean West: Why not?

Professor Loss: Because it is too fraud-prone without regulation, and it cannot afford the regulation.

Professor Benston: That is the question. One keeps hearing the statement that it is too fraud-prone. I suspect it is very similar to the problem of policemen having been on the vice beat too long. They begin to think of every female as a prostitute and every male as a pimp. The basic problem, if you take that attitude, is that you really want a society in which everyone has to register and have an identity card and be searched and frisked and kept off the streets because there is a possibility that a crime might be committed.

Let us assume that a small business has someone operating it in a manner that will defraud the public. I wonder to what extent there would be frauds that would disinherit all those widows and orphans. Remember, there is an alternative for widows and orphans—do not buy the stock.

The question is, if I may be so bold as to say: In a free society, should people not be allowed to take risks if they care to? By the way, I do not think there really is any way of stopping the greedy from being taken (whether it is by means of the pigeon drop or selling the Brooklyn Bridge or whatever) if they believe that there is some way of making a heck of a lot of money without taking many risks and without making a large investment.

Professor Loss: George, I am glad you said what you did, because I think you have shown the futility of our undergoing a complete reexamination of the disclosure philosophy. You know, one has to accept some things as given. It is a free country and you are entitled to those views, obviously. In my opinion, the chance that Congress would agree with you is absolutely nil; otherwise, I am literally insane for having wasted ten years of my life. We could not sit around and draft a code by debating whether in a free society people should have to wear helmets when they ride motorcycles.

I can see both points of view on that item. You have understandably a legitimate point of view, and there are a lot of economists like you. A lot of economists disagree with you, also, in your approach that the market can take care of everything. That is not the philosophy under which this country has operated since the thirties, and it is not remotely conceivable that it is going to shift over to that philosophy. And I do not think we should be criticized on the ground that, yes, we produced a Cadillac, but it will not fly.

Dean West: How about the direction? I agree with you, practically speaking; you are not going to go back to a "no regulation" environment. If you start at a particular point, is it possible that you ought to ask in which direction do you want to go from here? Do you want to go back a bit or forward a bit?

Profesor Loss: Well, we have done both. I feel like a yo-yo. Sometimes I am arguing with the Commission, sometimes I am arguing on the other side. If somebody else had sat down, would sit down now, and redo this in eight or ten years, a different line would be drawn. That would be inevitable. But there would still be a line drawn somewhere. You could not have an extreme of too much regulation or too little regulation.

Dean West: I agree with you in a sense, but the problem is that the tightening and loosening appear so incredibly ad hoc. It is not clear whether the objective is to tighten or to loosen. And you can say to me, "Well, that's inevitable in this area," but it is precisely that lack of any sense of overall direction that is so frustrating.

Professor Loss: With respect, there is a line in the Code. What we have done, basically, is to loosen in the old '33 Act area and to tighten in the fraud and civil liability areas. That is one rough line we followed. Now, how do you pick out a line in the drafting of a code? You could do it ad hoc by putting together several hundred changes, or you could try to follow a more or less logical philosophy, subject to some extent to political considerations, but not altogether by any means. We cannot ignore the political considerations.

Professor Wolfson: I think I should point out that it is debatable whether the '34 Act has been tightened. One of the reasons for redoing the '34 Act was the fear that rule 10b-5 had run wild. It has been redone, and one of the changes, for example, is to limit directorial liability. Now that might be a good thing, but that is not an illustration of tightening a regulation. That is an illustration of moving in the other direction.

Professor Loss: In the 10b-5 area, it is not a question of tightening or loosening. Our main aim there was to try to achieve some sort of philosophically consistent lines that have developed in this field—to try to make some sense out of measure of damages; some sense out of statute of limitations; some sense out of scienter; some sense out of *in pari delicto;* some sense out of the plaintiff's duty to investigate and so on and so on. Whether that loosens or tightens in each case, I do not know and I do not care to know.

Professor Wolfson: I agree that it is difficult to say whether it has been tightened or loosened overall one way or the other. There is no evidence that for every regulation which has been tightened, another has been loosened. Even if there were, we would not know whether the net effects of those changes would balance out.

Professor Kripke: We may be spending too much time on this limited offering thing, but I do think that it illustrates two or three points. In the first place, I have a somewhat longer version than Lou has told of the process by which we came up with the figure thirty-five. When that issue started and Lou picked the figure of twenty-five out of the old release, I protested because I had been looking at the evidence of the number of private placements as they showed up in the reports of secondary offerings which were registered in connection with issuer registrations. In each case, the prospectus disclosed that the so-called "selling stockholders" had received their stock in a private placement, and the numbers tended to run thirty-two, thirty-eight, forty-two. I argued that it was perfectly obvious that the private placements were being made with up to about fifty people, which is what it took to put together a group for a private placement. In no case were these widows or orphans; these were what we used to call "businessmen's risks," wealthy persons who were looking for capital gain.

The lawyers and brokers who were putting together these private placements were not interested in being sued by widows and orphans. They would not have accepted a widow or an orphan if he or she had tried to buy some stock. These were wealthy people who could afford to take the risk. The number tended to run over twenty-five and over thirty-five, and I suggested that the number be fifty.

While I agree with Lou that we cannot have an empirical investigation for every one of the hundreds of points that come up, I suggest that the experience which I announced at that time was by way of applying practical experience to a problem. I think Lou was prepared to go along with it, but at that point, Commissioner Loomis—who was not interested in empirical experience or even in the fact that the SEC had seen all these things and had not done anything about it—said: "I will go for thirty-five, but not fifty." That is how the thirty-five came.

Now, it is curious that later on, when the SEC picked the number thirty-five in rule 146, Chairman Casey bragged about the fact that the Commission had not just pulled the number out of a hat, but had relied on the wisdom of The American Law Institute.[14] [Laughter.]

Professor Loss: Well said.

Dean West: A complete circle.

Professor Benston: Let me pick up on that, Homer, and comment on something that Nick said in his presentation. While one cannot expect, as you said, that Congress would buy a complete change of the law as, perhaps, I would prefer, I think that you had an obligation—let me put it this way. It is all too easy to sit here, not having gone through all of those years of work, and then say: "Hey, you should have done this; you should have done that." Therefore, I apologize for the arrogance of my statement.

Professor Loss: There is no apology necessary; there is no arrogance.

Professor Benston: Well, I hope not. But, what I would have wanted is that some of these questions, such as that about which Homer spoke, could be presented to Congress with reasons supporting a change. If you are going to prepare an exemption based on fifty, one hundred or some other number of investors, it should be based on some evidence, such as the experience of lawyers, or perhaps on studies by economists. One cannot expect Congress to simply buy a change unsupported by evidence.

14. Casey, *SEC Rules 144 and 146 Revisited*, 43 BROOKLYN L. REV. 571, 596 (1977); *see* SEC Release No. 33-5336, [1972-73 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,108 (Nov. 28, 1972).

On the other hand, if one wants to protect somebody from fraud or from misrepresentation, or to try to "loosen up business," or (in terms of the quotation from Franklin Roosevelt)[15] not to impose on business, then one can look at the issue rationally, present some evidence and studies and say: "We have a reason for this change that is based upon this line of evidence." I think economists could have been useful to you for this purpose, had you asked, or had somebody asked us. And I do not mean me, personally. There are people, like Irwin Friend,[16] who disagree almost totally with what I say. Ask both of us. You are lawyers, you are used to hearing both sides of a case within the judicial procedure. See our briefs; take them into account. I presume that you would try to make an honest judgment. Just as we have helped lawyers with briefs in other cases, we could have helped in this case. I think that many of the questions at issue could have been researched.

And although I understand your political problems, we economists might have been of some help in terms of better understanding the ramifications of the values that anyone might hold.

Professor Sowards: Yes, sir.

Audience Member: Professor Benston, I am confused, very frankly. I can understand your statement about empirical studies, but I feel that your statement sounded like an objectionist's statement, when the fact is that the number thirty-five has existed in the drafts of the Code for some years, and economists, to my knowledged based on what you are saying, have not done any empirical studies. They did not have to wait to be asked by The American Law Institute to do empirical studies; they could have done it. Instead, I find, gentlemen, three of you sitting here saying: "But where are the empirical studies?" That does not quite make sense to me. Let me make just one other point, and then I will sit down.

There are two questions here. There are questions as to specific sections of the Code. And I can understand you may have difficulty—you may disagree—with various sections. For my edification, I would appreciate really learning: In principle, do you support the idea of the Code (forgetting about whether you agree with specific sections)? That is, should we have the Code or should we not, num-

15. The Code draftsmen attempted to achieve their goals, "in President Roosevelt's words, 'with the least possible interference to honest business.'" S. REP. No. 47 at 607 and H. R. REP. No. 85 at 1-2, 73d Cong., 1st Sess. (1933) *quoted in* FED. SEC. CODE at xv.

16. Irwin Friend, Richard K. Mellon Professor of Finance at the Wharton School of Finance and Commerce, is the author of numerous books and articles including Friend, *Required Disclosure and the Stock Market: Comment*, 65 AM. ECON. REV. 467 (1975).

ber one; and if so, if you agree we should, then let us get down on the specific questions. In other words, put it in context and take it orderly; I would like to know exactly where you stand.

Professor Benston: Let me take the first question. Dean West, if I do not cover it well enough, you come in right after.

Dean West: I am sure you will.

Professor Benston: One basic point is that I think we all work in response to incentives. I do not think that I, or anyone else, am an altruist with respect to many things. The reason that I, as someone who has done at least some research in this area, did not worry about the number thirty-five is because it would have been gratuitous of me to attempt to do some research and give it to someone who never asked for it. And it would have been senseless to send it to a journal that would never publish it, because the journals that I publish in could not care less about this particular question.

What we can do is the same thing we do when we are called in as experts in cases; that is, tell me what you are interested in and I will try to give you as honest and as competent an answer as I can. But I am not going to go around looking for these things. Frankly, I have got a lot to do, and I would not have read this darn thing [the proposed Code] if I had not been asked to come here.

Audience Member: What about the attorneys who expended $3 million of their own time?

Professor Benston: I do not know how much of that $3 million dollars was expended to try to answer some of these questions.

Dean West: Nobody looked at what we economists have done in the past. What reason did we have to believe that if we devoted time, anyone would pay any attention to us? There are a lot of results out there that just did not get looked at. And by the way, we did not do the research because we were asked. We simply did it because some of the questions seemed interesting. Back to George Benston's point, time is a precious commodity, and you do what you think is likely to have the greatest payoff. You look at the things where you think you might have a chance of having somebody listen to you.

Professor Benston: Just personally, I can say this: Professor Loss (whom I never met before, but whose work I have read and whom I admire greatly from that work) might have come to me and said: "Here is a question my committee is interested in. Could you meet with us and help us frame this question and see how we can investigate it?" I would not have asked about compensation in the usual monetary sense; but, just because he had cared to ask, the answer would have been: "Yes, I would be glad to, because you are asking." But I would not have approached him and said: "Hey, I can answer these questions. I will answer them for you," because I would have asssumed that if he did not ask me, he did not care to know—not from me anyway.

Professor Wolfson: I think it is debatable whether one can analyze the number thirty-five and whether that number is important. But I think it is unfair to say to the world, including economists, that this problem was in the form of a complaint filed with you, and because you failed to file an answer, we have a default judgment against all social scientists. [Laughter.] I think that if it had been important to find out what the answer was, there were methods to do it. We do not work by default in these situations.

Dean West: One more comment on the process issue. Professor Loss said a moment ago, if I am paraphrasing him accurately, that the method of writing the Code is very similar to the way most things are being done in relation to legislation. He mentioned the tax situation, for example. I guess my reaction is that this is a least common denominator argument of the type that is killing us. It is one of the reasons why there is so little public faith in anything that is getting done. There seems to be no basis for explaining why Congress goes off and does what it does, except that a particular group which has some axe to grind has worked on it. I really feel that if somebody was prepared to spend $3 million on this project, they should not only have produced a good Code but also have described a process that, hopefully, might become a standard for other such efforts. The next time the tax law gets rewritten, Congress might then say: "We do not want to hear you until you do things the right way—the way the Federal Securities Code was done."

Professor Sowards: All right, ladies and gentlemen——

Professor Loss: I am reminded by something I saw on television recently of the six or seven study groups that the British Government sent to Palestine, which resulted in their just pulling out.

Professor Benston: That is probably why individual social scientists or lawyers or whoever do not gratuitously give their services. One would want some reward: the reward that at least somebody asked you; the reward that somebody might listen; or, in the absence of either one of those two, money.

Dean West: I agree with you that economics is the dismal science, for reasons that we will not go into, but I do not want to see law be the dismal art. [Laughter.]

Professor Benston: But, I did not mean to duck your second question. I know there is one thing in which I have no comparable advantage; that is, what will get through Congress. So, when Professor Loss says it will not fly, then I presume he knows. I certainly do not. But I can speak about the concepts that the Act was supposed to be concerned with, and I can talk about the realities, because my research and reading on much of the Depression or New Deal legislation revealed that these tended to be special interest acts that were put forth by people who were waiting in the wings, prepared to get something for themselves at the expense of general public.

For example, I have researched several aspects of the Banking Act of 1933[17]—in particular, the prohibition of interest payments on demand deposits. The argument that the prohibition was required to prevent bankers from taking undue risks as a consequence of their having to pay interest on checking accounts was dreamed up later. The Act, was, in fact, cartel legislation that benefited the banks at the expense of their depositors. And, now it is collapsing of its own weight. The rationale for the securities acts, as far as I can tell, also was not based on any evidence at all, or any evidence of the fraud and widespread problems now are said to have existed then.

We had a Great Depression. People lost a lot of money. The Banking Act of 1933, the Glass-Steagall Act,[18] prevented banks from underwriting securities. Everyone assumes that the Congressional hearings showed that the banks and their investment affiliates did not maintain a "Chinese Wall" between their lending and investment activities and that they did all kinds of nasty things with other people's money. But, no evidence has been put forth to show that this ever happened. I am not saying it did not happen. I am just saying there never was any evidence one way or the other. But we do have evidence that some people wanted that Act because they were trying to keep the banks from competing with investment bankers. And, they were successful.

Now, this is what I would like. I would like us at least to consider the basic rationale of the Act: protection of the public, prevention or reduction of fraud, efficiency in the securities markets. We already have some research available. Additional research could provide more insights and evidence. But at this point, I can say that the research that I have done and read—and I am willing to change my mind—leads me to the conclusion that the professed values that the Act seeks to support are not being supported, in fact, by the

17. Banking Act of 1933, 12 U.S.C. §§ 21-215b (1976).

18. 12 U.S.C.A. § 24 (West Supp. 1979). Section 16 of that act was aimed at prohibiting national banks from going into the investment business. Investment Co. Inst. v. Camp, 401 U.S. 617 (1971).

disclosure aspects of the Act, which is one thing I have researched.

Accounting data are not sufficient and were never designed—and conceptually can never be designed—to provide the kind of disclosure that people have in mind when they say they want disclosure. The American Institute of CPAs and the Financial Accounting Standards Board are conceited in saying that people cannot make investment decisions without the kind of numbers that accountants produce. It appears, rather, that they have done what I am afraid other people do; namely, feather their own nest at the public expense. I know that Professor Sowards is trying to get in.

Professor Kripke: I empathize with Lou in his remarks about trying to use economic data and the fact that the economists do not agree. I have been trying for the last several years to understand the new economics of the securities markets that I referred to this morning. Part of the difficulty is that economists cannot write English, they can only write "Mathematics." The second part is that every time one of them writes—even if you skip the math and read the conclusion—then somebody else comes along and says that the math is all wrong; therefore, the conclusion is not valid.

When you get all through with those dificulties, there remains finally a minimum consensus that lawyers can use. For instance, there is a consensus among the finance and economics and the empirical accounting groups that the market is quite efficient; that it reflects information very rapidly; and, therefore, that the disclosure system which caters to people making investment selections is probably misguided, because anybody who thinks he is going to make a profit in the market by analyzing old statements is just kidding himself. There is a consensus that the information requirements of anybody who does try to make a decision have to be infinitely broader than can be gotten out of any SEC documents—partially for the reasons George Benston just mentioned about the role of accounting; partially because of the influence of the macroeconomy which affects a company's future as much as its individual situation does; and, partially because, while the economists are not in full agreement, it is perfectly clear that most securities fluctuate with the market. Unless you address yourself to what the market is going to do as well as to what appear to be the merits of the individual security, you may be just wasting time.

Now, what should be the consequences of all that? I do not know. I have been pondering it for five years. I wish to hell our groups had taken the time to discuss it to see whether our collective wisdom would have been better than my individual wisdom.

Professor Sowards: An overall criticism of this proposed

Code—and there are serious questions as to whether or not it is well-founded—is that it grants expanding and excessive rulemaking power to the Securities and Exchange Commission. The Attorney General's recent speech at the University of Kansas pleading for a curtailment of rulemaking power; the Sears & Roebuck action against federal agencies, apparently a cry from the regulatory quicksands of affirmative action; the Alfred Kahn deregulation of the airlines and proposed deregulation of other industries, are the order of the day. These are signs of the times.

Justice White, in the same vein, in *Santa Fe,*[19] stated that rule 10b-5, that famous or infamous, depending on where you sit, rule

> was adopted pursuant to authority granted the Commission under § 10b. The rulemaking power granted to an administrative agency . . . is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute . . . .' [The scope of the rule] cannot exceed the power granted the Commission by Congress under § 10b.[20]

Rule 10b-5 is a case in point; its beginnings were questionable.[21] But, its ramifications have been dynamite. This rulemaking power bothers a lot of us. Professor Loss, himself, back in 1966, in discussing 10b-5 and how the rule had run rampant, said this, which I have always remembered: "What has happened in Rule 10b-5, and this can be true of other rules, always reminds me of a cartoon in the *Times* showing Mussolini dictating to his secretary. The caption was: 'Take a law, Miss Bacigaluppi.' " [Laughter.]

Does the proposed Federal Securities Code grant this kind of rulemaking power? If it does, then I think we are in trouble. And I would like Professor Loss—may I ask him to respond to this first?

Professor Loss: Well, first of all, I believe in the rule of law, the Ten Commandments and many things. I am uncomfortable with quite a few of the Commission rules as being overly extensive. I think more likely than not that, if somebody were to retain me, I could persuade the Supreme Court, at least today, that probably the whole 140 series is ultra vires, that the Commission has gone far beyond "defining . . . technical terms"[22]—which is what they are

19. Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977).

20. *Id.* at 472-73 (quoting Ernst & Ernst v. Hochfelder, 425 U.S. 185, 212-14 (1976)).

21. For background information about the origins of rule 10b-5, see Freeman, *Conference on Codification of the Federal Securities Laws: Administrative Procedures*, 22 BUS. LAW. 793, 891 (1967) *cited in* H. SOWARDS, CORPORATION LAW 8-132 (2d ed. 1978).

22. Securities Act of 1933, § 19(a), 15 U.S.C. § 77s(a) (1976).

supposed to be doing—when they create four-page rules complete with filing requirements.

Professor Kripke: You just made a very quotable remark, Lou. I see the reporters writing it like mad.

Professor Loss: I can always say I was misquoted. [Laughter.] Second, the real branch of the government that ran with the ball on 10b-5 was not the SEC. The SEC just said: "Fraud is fraud." It was the courts—aided and abetted by the SEC as amicus curiae, to be sure—but it was the courts that really ran excessively with this ball, to the point where an innocent misstatement was pretty soon going to be fraud.

Third, when all is said and done, I do not think there has been any significant extension of the Commission's rulemaking authority. I do not know how you weigh these things. We have been careful wherever possible to draft in such a way that it is lawful to do things unless the Commission says otherwise, rather than saying it is unlawful to do something unless the Commission permits, so that inertia works against the Commission and not with the Commission.

In the last analysis—I have said this once or twice before today—I would not have known how to draft a code without broad rulemaking authority in the Commission, even if it may have been abused on occasion. In the last analysis, the real governors of the Commission's rulemaking authority have to be the congressional watchdog committees. There is some indication that they have become a little more careful than they have been in the past. I wish it were possible to decrease the amount of rulemaking. It simply is not possible without putting into the Code a lot of what would otherwise be in the rules, and then you get far too technical and too brittle and you need amendments too often, for you cannot anticipate everything.

Let me give you one example. The Securities Act of 1933, as you know, has a Schedule A, which lists the sort of stuff that is supposed to go into the registration statement, and then the statute gives the Commission power to adopt forms and rules. Well, it has been a long time, I think, since anybody ever looked at Schedule A. Very early one of the Advisers, in discussing one of my early drafts, said, "What do you need Schedule A for?" So we now say that a registration statement, an offering statement, a proxy statement, a report, should contain whatever the Commission requires. That has been the reality for the last forty years. Now, does that expand rulemaking power? It does literally, but not as a practical matter. It just recognizes reality, because otherwise you have to specify twenty-five items and then give the Commission authority to change them; and since you do not have to do that constitutionally any more, you are just wasting paper. Rightly or wrongly, that was our theory on that.

I would like just another word, two other words, if I may. Dean West talked about our tightening up of the tender offer provisions. But he apparently did not notice that the rationale for doing that was that we are preempting the thirty-five state statutes, which are blatantly pro-management, and we thought the only way politically that we could do that was to tighten up somewhat. I do not think we have made it a pro-management section. There is not any litmus paper that tells you exactly where you draw a line in order to have neutrality. There are many people of good will who think that the present Williams Act does not go far enough.

In any event, with thirty-five state statutes going much further in varying degrees, the real law now is state law, depending on what the Supreme Court says in the case it has just taken.[23] You cannot ignore the fact that thirty-five legislatures have gone further. So, what we did was to go somewhat further, but not a great deal, and then preempt all the state law. And I think the net effect of that should be beneficial from the point of view of your philosophy.

Dean West: I am aware of that. You make that very clear in the notes; and to the degree that the net effect is less regulation, I suppose that I would have to agree with you. I am not sure it will be. The thing that scares me is that at the same time this is happening with the Code, the SEC is running even faster to control tenders. And, I am sure that they are going to argue, in part, that they are doing this because the Code is moving in this direction.

Professor Loss: Well, for the last nine years the Code draftsmen and the SEC have been sort of complementing each other. We have been following them; they have been following us. Some things they have been holding off for the Code; some things they have been doing. I suspect, although I cannot prove this, that they were able to swallow some of the rules they have adopted on the theory that they are only temporary until the Code comes along.

The other point, the one I would like to finish with, is borrowed from Ray Garrett, Jr., who, as you know, was Chairman of the Commission for a couple of years and has been active as a consultant on the Code. He referred to those people who say: "Well, this is not the time for it because things are too complex, or they are working out this, or they are working out that; it is not time for it."

23. Leroy v. Great Western Corp., 439 U.S. 1065 (1979), *noting prob. juris. sub nom* Great Western United Corp. v. Kidwell, 577 F.2d 1256 (5th Cir. 1978).

He made the point that there is never a time for it. And, he said it reminded him of a former mayor of Chicago—I forgot which one—who said, "Chicago ain't ready for reform." [Laughter.]

Audience Member: Could I make a comment or maybe ask a question about the rulemaking power that has been granted to the Commission in the new Code? Particularly, in section 1818 on judicial review, the Code eliminates the use of the substantial evidence test.[24] It requires——

Professor Loss: No. We left it out only because it is in the Administrative Procedure Act,[25] and we did not want to say it twice.

Audience Member: OK. There are various statutes that Congress has passed which require certain findings and also make provisions that, on judicial review, the court is to use the substantial evidence test. Wouldn't it be possible—even though you must give the SEC certain rulemaking power, which really sort of places a gloss over the Code—as one means of providing for the empirical evidence that we have heard so much about today, to require certain findings on the part of the SEC before they could promulgate a rule, to support it with some sort of empirical evidence? In other words, Congress could require, before the SEC could actually promulgate a rule, that there be certain findings made in support of the rule; and then, in addition, by providing for the substantial evidence test, as opposed to simply the arbitrary and capricious test, the court would have the opportunity to review the evidence that would be given by both sides. This would prevent the SEC from simply promulgating one rule after another and would probably give a better chance of challenging the rule.

Professor Loss: Well, I think the Administrative Procedure Act already requires certain findings, not necessarily empirical findings. At any rate, the Commission makes them. I cannot believe it would be practicable to say that there must be empirical studies. How would you define what were sufficient empirical studies? But I am glad you raised the question for another reason. I neglected to point out that the judicial review provision,[26] for the first time, would give the courts of appeal authority to review all rules, not just certain rules—but under a "ripeness" test. So, that is something that will safeguard against excessive rulemaking.

Audience Member: Maybe if I could make one other comment. The Consumer Products Safety Act, which is a statute which Con-

24. FED. SEC. CODE § 1818.
25. 5 U.S.C. § 706(2)(E) (1976).
26. FED. SEC. CODE § 1818(b).

gress passed in 1970,[27] specifically provided for certain required findings that included a benefit analysis, basically, and certain empirical evidence before they would ban certain products from the market, including the effect that the banning of the product would have on the market. Now, I really do not see why the same kinds of requirements could not be provided for in the Securities Code, requiring the same kind of findings in terms of cost/benefit, particularly in light of the limited offering requirement—what is the actual effect on the small starting company?

Professor Loss: Well, I get your point. I think that it has some validity. My immediate reaction would be that that is the sort of thing that should not be in legislation because it would not be very meaningful. I would not know how to draft it. It is the sort of thing that the Commission ought to do to the extent practicable and, if it does not do it, the congressional oversight committees should get after them for not doing it.

Professor Benston: I think it would be helpful to recall the old adage, "The best is the enemy of the good." I sometimes feel that the practical is also the enemy of the good, and perhaps the difficulty that one has in being so close to working with the SEC, working with the bar and the others, is that one sees everything primarily in such practical terms—What will they accept?—that it becomes very difficult to achieve perhaps that which one would have liked to have achieved.

I think the Attorney General is quite right and is in accord with Professor Sowards' comments about rulemaking by agencies such as the SEC. I have recently been doing some FTC-related work. The rulemaking that they are engaged in is imposing enormous costs on the economy, on individual companies and on people. They are advocates for a particular point of view, and they seem sometimes just to impose almost any ideas that they happen to have on the economy. In the academic world, many of these proposals would be laughed out of existence, but the FTC economists are in positions of power, and they can attempt to impose their proposals on others, and it is very hard to stop them. Therefore, the more restrictions on this rulemaking one could have, the better, for the simple reason that once this authority is held by an agency, it almost has to be used. It is inevitable. There is just no way that the people who have that authority are not going to use it, because if they see a problem,

27. Consumer Products Safety Act of 1970, 15 U.S.C. §§ 2051-81 (1976). The speaker is apparently referring to § 2058(c).

they will try to solve it, and they catch hell if they do not appear, at least, to be solving the problem.

Professor Loss: That simply is not so. There are a fair number of rulemaking authorities that have been in this legislation since the beginning and that the Commission still has not used. They do not use all of their rulemaking authority—not by a long shot.

Professor Benston: When Andy Barr was the Chief Accountant of the SEC, I was happy because he generally refrained from using it. But it always bothers me that the agency has that loaded gun and that somebody might be appointed who decides that using it is the way to make his way in the world, or he may honestly believe that he is doing good, but for whatever reason, he can use that weapon on somebody who cannot protect himself.

Professor Loss: Let me say, I do not take lightly what you say or what Dean West has said. Perhaps, all that we have demonstrated is that lawyers and economists have a little difficulty understanding each other. I am not an economist. I wish I were. I cannot laugh off what you say. I have anticipated that criticism; it is the one that worries me more than any other. I have no answer except the one I have given, which may or may not be good enough.

The one thing I know is that, if the ALI or some other body had undertaken a ten-year study of the philosophy of securities regulation, that, at its best, would have produced only a report, and we did not set out to do that. We set out to make some sense out of seven statutes and some thousands of cases that have produced chaos. And, we did it as lawyers. And I think at this point, all people of good will have to decide—not: "Would I have done it differently? Would I have done it better?" but—"Shall we take it on balance, because this is the Code that has been prepared in almost a decade of work by many expert minds. Somebody else might have done a much better job. But, after ten years, this is it. Would this be on the whole better than what we have now?" I think that is the question.

Professor Sowards: Indeed it is, and I am really pleased, but I worry, Lou. I do not want to belabor this, but take the thirty-five orphans. In the start-up company, where it counts with me (maybe I am selfish because this is new country and that is what we have), if the SEC, the cop, can write a rule—and you *know* they will—can't they knock us out of the box? And if they can, I do not like that. I like your thirty-five, I would like to leave that alone. Why do we have to give—and you have, with less than a one-year registrant—authority to add, subtract or really rewrite? Maybe that is where the area of protection is most dangerous. I do not know. But wasn't this country built that way? How can we get off the ground otherwise? And believe me, it is hard to get off the ground under rule 146, which is where we are this afternoon.

Professor Loss: Well, Hugh, here I find myself in the middle. Last week I was debating with the SEC staff, which would like a rulemaking power put in as to all companies. Now I must debate with you about leaving it in as to non-one-year registrants. The fact is that in all of the drafts until about a year ago it was in as to all companies. I then took a deep breath and said: "Well, let's take it out except as to non-one-year registrants and see whether the Commission explodes." So far they have not exploded. They may still. But, again, all I can say is—and I am not an expert on politics by any means—that, as I see it, we *might* have a chance (I do not put the chance too high) that Congress, over the SEC's objections, would give us a flat thirty-five as to one-year registrants. But I do not think there is *any* chance that, over the SEC's objections, Congress would give us a flat thirty-five rule——

Professor Sowards: For less than the one-year registrants?

Professor Loss: Exactly. That being so, I have to temper principle by practicality.

Professor Benston: May I make a practical suggestion. I do not know how much time you have and how this is going forward, but from what you said earlier——

Professor Loss: Well, life is finite.

Professor Benston: Well, that is true, but we do proceed on the ground that it is not going to end instantly. Otherwise, I would be outside in what sunshine there is left.

For example, consider this particular instance. Obviously, there is a lot of concern about it. This is a case where, perhaps, the ALI should contract with the University of Miami's Law and Economics Center, which has economists and lawyers, to research this question. You know, to try to do an analysis on what the effects would be of raising the number to fifty or raising it to one hundred. To study this question, one needs a combination of lawyers and economists. I do not know if they have any accountants, but I do not think that any are needed for this question. The point is to try to get some evidence, on the assumption that the Commission is really trying to protect people.

Let us assume that the Commission is not objecting to an increase in the number just to make trouble, but because they really think that they are doing good. We want to meet their arguments, if they have any. The counterarguments include the effect of the current rule—stopping business from getting started despite the fact that many investors are really quite sophisticated. I think that if the Congress were aware that there was a good piece of work done that showed that these investors really were sophisticated, or that there really were no widows and orphans who would be hurt under these conditions, or that there was a way of handling the situation to see that they would not be hurt, then no one would have any serious objections to an increase in the number.

So perhaps here is a place where a study could be commissioned. The reason to commission it is because I think that if I (and I do not want to do this study, by the way), but if I, as an economist, just did a study, no one would listen to me. I would have to be asked by someone with your prestige to do this research before anyone would pay attention to the findings.

Professor Loss: With all respect, I do not think you are right.

Professor Benston: No one has listened to me yet; why should they start now?

Professor Loss: We would read anything that you wrote just as we have read carefully everything that quite a few lawyers have already written in a few law reviews about the Code.

Professor Benston: Let me put it this way, I would be listened to, but not paid attention to.

Professor Loss: We have not paid attention to all the law reviews either.

Professor Benston: I am suggesting that this is a case where the structure of how the research is undertaken would be meaningful. Researchers would be willing to undertake it because they felt they would be taken seriously. I have no evidence that the work that most economists have done in this area has been taken seriously.

Professor Loss: Well, as at least a pseudo-professor, I am not going to be in a position of objecting to the advancement of knowledge. So, in principle, you are quite right.

Professor Benston: I see my suggestion has not been taken. [Laughter.]

Professor Loss: We have run out of money for one thing.

Professor Benston: Well, maybe there will be altruists.

Professor Sowards: George, may I? I have one more problem that has been raised time and again, and I know you are sick of it. It is the civil liability, especially as it concerns outside directors. The two sections of the proposed Code (and again numbers are unimportant, but for those who wish to write them down, sections

1704 and 1705)[28] and the theories that the liability of directors, as concerns the annual report, may be a strict one without the scienter defense, for example, of *Hochfelder.*[29]

I recognize that since continuous disclosure is a watchword of this proposed Code, as it should be, the emphasis has shifted from the registration statement to the annual report, the form 10-K. And, I also stated to you in my opening remarks today that, happily, I think, Professor Loss has suggested a compromise so that, as I understand it, the language is placed in brackets so that Congress can put the liability of directors, other corporate officials and those associated with the company into the general fraud section—1705—rather than under 1704. I have still had many people express concern to me, Lou, that this represented a distinct departure from what we have now. And, *Barchris*[30] has made it hard enough to get first-rate men and women to serve so that, should this first alternative—let me put it this way, should section 1704 be adopted, it would mean a severe setback for first-rate people serving. Would you please respond to that?

Professor Loss: Well, Hugh, as I think I said before, that is a very good argument and roughly half of the advisory group agree with that argument. Roughly half disagree with it and make the other argument—that we would be diluting the net effect of section 11 of the Securities Act if we did not impose section 1704-type liability, section 11-type, on the annual report. Under those circumstances, the only honest thing we could do was to report to Congress the truth, that we could not reach agreement and, therefore, the Institute as an Institute takes no position.

The report to Congress will summarize the arguments on both sides and say to Congress: "This is where you are on your own. You are simply not getting any advice from the Institute." Now, it occurred to me belatedly that it was all right to put things in brackets in these publications, but when a bill is drafted, you cannot put things in brackets. And this is one of three respects in the entire Code in which we have brackets. In those instances I have simply reached an understanding with the House subcommittee staff that, when the bill is drafted for introduction, they will decide which version goes in the text and which version will have to be the subject of a comment. Whichever way that goes, that is simply a question

28. FED. SEC. CODE §§ 1704-05.

29. Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

30. Escott v. Barchris Constr. Corp., 340 F.2d 731 (2d Cir. 1964).

on which we were unable, literally unable, to reach anything like a consensus.

Professor Kripke: I would like to comment on that point because I guess I am not a member of either half. I take the position that putting so-called section 11 liability on annual reports for anyone, not merely the outside directors, was a mistake.

Professor Loss: No. We have expanded the no-action position to include anybody.

Professor Kripke: I know you have now done it, but Professor Sowards addressed it in terms of the outside directors only. I wanted to take the position which led me on the floor to oppose this for everybody. It is one thing to continue to support, forty-five years later, section 11 of the Securities Act (which was adopted in the atmosphere of 1933) as applied to registered issues. Registrations of public offerings happen only episodically in most companies. When they do happen, because of the section 11 liability, everybody gets excited and the lawyers lecture the directors and officers about how important it is. But, when the company is getting new money, or even in case of secondaries, where Congress thought that the sellers stood in the position of the company (either control persons or people who bought from the company with a view to distribution), the argument can be made: "Well, if the company made a mistake even inadvertently, the least they can do is give the money back." But, when you shift from that case to the annual report, and there is no new money coming in and there is no limit on the group of people who can be plaintiffs—namely, the people who bought the issue—and the threat of litigation comes from every stockholder who bought the stock during the period, from every stockholder who sold the stock during that period, and conceivably from people who neither bought nor sold (although that would not be present law), when you shift like that, you require that every time there is an annual report, then the officers, all of the directors and the public accountants must approach the report with all of the burdens of Securities Act registration, a convulsive effort. There will surely be some entrepreneurial lawyer finding some client, who either bought or did not buy or either sold or did not sell, and filing a class action suit saying that the stock went up or down—somebody was injured. To make this case, he does not have to prove that he relied on these statements. He does not have to prove damage. The whole statute is designed to throw all of the burdens on the company and on its officers, directors and accountants. There is no reason at this stage of history why we have to have any such draconian liability on the annual reports.

Professor Wolfson: I would like to make some general remarks on this issue of directorial liability. It is interesting to note that for forty years now we have had some form of liability imposed on directors, either by section 11 or other civil and criminal sections, and, indeed, we have liability provisions in state statutes. The purpose of these statutes was to make directors of publicly held corporations honest and worthy of our trust. One would assume that the various securities acts measures supplemented by state measures—one would hope that all of those regulatory procedures enforced by a Commission injunction or by private suit would result in a situation where we said: "Aha, the reform of yesterday has produced an acceptable level of directorial behavior." In other words, the purpose of these statutes was to modify behavior.

But, what we have now is a great movement among the SEC and others, which claims that we need a total reform of corporate governance because the directorial system is not working. For some reason, it is claimed that the reforms of the last forty years do not work. You have, for example, the Chairman of the SEC saying in a speech that the large privately held corporations are not really private.[31] He said that they are essentially public entities and whatever has been done in the past is not enough; therefore, we need a whole new paraphernalia of regulation which includes the right to impose independent directors. And, of course, other suggestions go even further. My point is that there should be some relationship between these statutes and behavioral modification.

I suppose it is conceivable that the statutes which have existed, which some view as draconian, have no impact and should be changed. It reminds me of a remark by Professor Milton Friedman that the definition of at least a 1930's form of liberal was someone who said the regulation up to then has not worked and, therefore, we must have more. That may be true, maybe we do need more. But we have this recurring question: Do the liability provisions which now exist—which are enforced with great vigor by Stanley Sporkin[32]—work? What I ask seems like a very simple question. But, do we know whether the current liability provisions are working? Are they making directors more or less honest? Are they having any impact? Before you begin to change the liability provisions, we have to ask: What is happening today?

31. In Chairman Harold Williams' speech, delivered to the Fifth Annual Securities Regulation Institute, he made the point that large public corporations are really "quasi-public institutions." [1978] 437 FED. SEC. L. REP. (BNA) A-22.

32. Director, Enforcement Division, Securities and Exchange Commission.

Now, some people say—I mean, if you went to Ralph Nader, he would say—that none of it is working. And, if you go to some Commission staffers, they express great disquiet. Again, there is this question: Are the current liability provisions having some impact on the directorial behavior of publicly held corporations? If we cannot answer that, we cannot answer the question of whether the Code changes will have any impact. And, if we say that we are not interested in what the current laws are doing because it is too difficult to investigate it, then what the hell are we talking about? We surely are talking about lawyers' fees if nothing else.

I say that we have to ask: Are directors being made more honest by these regulations? If not, then what are we doing? These are not simple questions to answer, but this is what it is all about. And let me say this—my economist friends can correct me—if we do not know what the current benchmarks are doing, how do we proceed to set future benchmarks with any rationality? I do not see it.

Professor Benston: Well, I could say, "Amen." I tell you, as an accountant and a CPA, I am sort of sorry that I am not back in practice now if this goes through.

Professor Loss: What you want to do is be a financial printer.

Professor Benston: Oh, amen to that. It happens that that was in a case where, in fact, printing may have been an important factor. But, the problem is all of these costs have to be borne by somebody. No one works for free that I know of, except academics, of course, because we know that we are doing so for the public interest.

Professor Kripke: Except members of the ABA and ALI committees.

Professor Benston: Yes. We do not always act in a self-serving manner. I am sure that is true, and it is true of all of us no doubt. But, the problem is that the net effect of the Code will be to make the audit much more expensive because, from the people who write a number down in an audit to the printers, there are just zillions of places to make a mistake of one sort or another. You can double check and you can triple check, and even then there may be mistakes, such as the printing mistake in this volume that Dean West mentioned—"le" instead of "al." All of these things can occur.

One of my doctoral students, Bob Kellogg, who happens to be an attorney, is doing an empirical study of fraud cases against accountants and the effect of these on the market price of the company's shares after disclosure of the presumed fraud—or at least a charge of fraud or misrepresentation—and what happened throughout the case. He is doing it with a very sophisticated model, the kind that Homer says most people cannot understand. If he did not do it that way, we would not accept it; that is true. Because, you know, we have our own jargon, too. He is finding that, for a large segment of these cases, the decline of the price of the stock occurred well before the offense was alleged to have occurred. In many of these situations, it appears that when a corporation has gone bankrupt, people have looked for someone to pick up the tab. The only survivors are CPA firms, which, being general partnerships, have lots of money because the partners are all individually liable. Now, the CPAs are not going to pay the tab, ultimately. They are just going to put this "insurance premium" into their fees, and it is going to be paid for by the consumers of the products, which is to say, by all of us.

If there were a real problem, it might be worth the costs. For example, setting automobile pollution controls to keep people from breathing bad air at least yields some measure of benefit. There may be a question as to whether the benefit is worth the cost, but at least we know there is a benefit. With respect to the securities laws, at a minimum we ought to find out exactly what are all of these problems that the law is supposed to solve. Do we know, does anyone know, that, because 10-Ks have not been subject to the 1933 Act section 11 liabilities, financial statements have been coming out that have been grossly negligently prepared, or are likely to be negligent to the extent that it would be worth the extra cost? The question is whether anyone in advance would have said: "I am willing to pay to be assured that these kinds of mistakes do not occur," rather than the ex post statement: "Who can I stick for the loss I took? Whom can I sue?" I have attempted to answer some of these problems, and you say: "Well, do your research and we will read it." I have done my research. I have looked at some of these issues and I know lots of other people have looked at them. What Homer said is correct. We see no evidence that this kind of problem has given rise to lawsuits, except in a very few instances where people really cooked the books or made gross misstatements.

Even then, in many of those cases, it was very unclear as to whether preventing the error would have been worth the costs. As any auditor knows, at some price you can eliminate perhaps not all fraud, not all problems, but a lot of them. But, few investors would be willing to pay that price. It does not make sense. A human life is not at stake. It is not as if somebody would die or there would be no more of that very precious commodity, life, if all errors are not found. Only money will be lost, possibly. For example, when I rent a car, I decide: Do I want to pay an extra $3 per day for the extra insurance protection of $200 if the car is damaged? Alternately, I can decide to take that risk myself. I, personally, decide to take the risk and save the premium.

Professor Loss: I agree with you.

Professor Benston: Someone else might decide to pay. But I do not understand why the government would say: "You have got to pay, say, $50 per day to cover yourself on this risk." Why should they want to do that? Why do you want them to do that? Why did you not fight this?

Professor Loss: Because I did not want to offend half of my advisers.

Professor Benston: That is not a good enough reason.

Professor Loss: Well, it is for me.

Professor Benston: I am sorry; I should not have said that.

Professor Kripke: It seems to me we ought to say here not only that Lou has taken a fair amount of pressure today, but also that he has had an unreasonable taskmaster in the SEC, trying to think of what they would require and sometimes knowing what they would require. He has been down there any number of times. The SEC is an unreasonable taskmaster, and the best way to illustrate it is with the recent *Daniel*[33] case where the SEC inflicted a wound on itself by arguing an absolutely preposterous position in the Supreme Court, which would have put a vast burden of regulation and tension on all kinds of pension plans just for the sake of enabling the SEC to play Sir Galahad once in a while on a hard case like the *Daniel* case.

Now, that is the kind of moralistic attitude we face, and the same attitude shows up in what Lou said a little while ago as an estimate of SEC position—that if he tried to have an absolute number of thirty-five persons on limited offerings not subject to rule, the SEC would not go for it, and Congress would not go for it. Well, the world can never be perfect and the amount of burden and possible regulation that would come out of the SEC trying to block every possible example of misuse of the limited offering exemption would just be out of balance in terms of the regulation required. And, now that Congress is sensitive to the expense and burden of regulation, I am not convinced that a presentation of the issue to Congress would fail. The point is that in order to cover a possible abuse in relatively few cases, we would have to open up an excessive regulatory burden. I am not convinced that Congress would not buy that position today.

33. International Bhd. of Teamsters v. Daniel, 99 S.Ct. 790 (1979).

I repeat that private placements have not gone to widows and orphans. Despite Hugh Sowards' remarks about raising money among thirty-five widows and orphans in Miami, I know he would not do it because the antifraud laws would reach him whether or not the disclosure laws would reach him. Private placements as they were conducted before rule 146, before the SEC got all excited about it, were cases in which lawyers and brokers, concerned about liability, and for their reputations, picked carefully the people to whom they sold. The people to whom they sold might not all have been sophisticated, but they fell in the category of what we call in New York, "Park Avenue doctors," people who were wealthy enough and aware enough to be willing to take risks. I am not convinced that the SEC can continue to build this vast burden of regulation to avoid the once-in-a-while abuse, because even with all the present regulation, as somebody pointed out today, we have Equity Fundings[34] and we have other such cases. You cannot avoid all the abuses in any case.

Professor Sowards: Professor Kripke, thank you for those remarks, with which I agree 100%. All good things must come to an end. Our time is gone. I want to say, in conclusion, I am really proud of our conclave today. I hope you learned, and I know I did. Although you may not agree with specific provisions, as I do not, as Professor Kripke does not, we have had, and were privileged to have had, the top people and the best man in the world. I want to thank him and I want to thank them for coming. [Applause.]

34. The Equity Funding situation involved a massive securities and insurance fraud which came to light when Equity Funding Corp. of America filed for bankruptcy in April of 1973. Litigation ensued in district courts throughout the country involving creditors attempting to procure some share of what was left of the company. An overview of the whole scandal, including the SEC involvement, can be found in Nerman, *Equity Funding, Inside Information, and the Regulators,* 21 U.C.L.A. L. REV. 1 (1973).